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No. 00-459

IN THE

Supreme Court of the United States

SALVADOR A. and KATHLEEN M. GAUDIANO, GARY D. ASHER, LARRY A. ASHER, and RANDY C. and KATHLEEN R. EDGEMON,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

This case presents a question already accepted by the Court for review on May 1, 2000 in *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), *cert. granted*, 68 U.S.L.W. 3497, 3680 & 3684 (U.S. May 1, 2000) (No. 99-1295), that is, whether, in conflict with the holding of *United States v. Farley*, 202 F.3d 198 (3d Cir. 2000), *petition for cert. filed*, 68 U.S.L.W. 3670 (Apr. 17, 2000) (No. 99-1675), the court of appeals below incorrectly determined that tax attributes subject to reduction under 26 U.S.C. § 108(b)(2) must be reduced in the year that an insolvent subchapter S corporation realizes cancellation of indebtedness (COD) income, despite 26 U.S.C. § 108(b)(4)(A)'s requirement that tax attribute reduction "shall be made *after* the determination of the tax imposed . . . for the taxable year of the discharge" (emphasis added).

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Petitioners Salvador A. and Kathleen M. Gaudiano, Gary D. Asher, Larry A. Asher, and Randy C. and Kathleen R. Edgemon respectfully request that this Court issue a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The Commissioner of Internal Revenue issued Notices of Deficiency to Petitioners, who timely petitioned the United States Tax Court to review the proposed deficiencies. The United States Tax Court affirmed the Commissioner's deficiency determinations in an opinion unofficially reported at *Gaudiano v. Commissioner*, 76 T.C.M. (CCH) 858 (1998), App. 30a, and entered decisions consistent with the same on January 12, 1999. The United States Court of Appeals for the Sixth Circuit affirmed the Tax Court decisions in an opinion reported at *Gaudiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000). App. 1a. The Sixth Circuit denied the Petitioners' Motion for Rehearing on July 18, 2000. App. 57a.

STATEMENT OF JURISDICTION

The United States Court of Appeals for the Sixth Circuit entered judgment in this case on June 8, 2000. The court of appeals denied Petitioners' petition for rehearing on July 18, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of §§ 61, 108, 1366, and 1367 of the Internal Revenue Code of 1986 (Title 26 of the United States Code),[1] as applicable in 1993, are reproduced at App. 58a-62a.

STATEMENT OF THE CASE

I. Relevant Facts

The facts are not in dispute, and are set out in the parties' Stipulation of Facts. App. 45a. During 1993 and relevant prior years, Petitioners Salvador A. Gaudiano, Gary D. Asher, Larry A. Asher, and Randy C. Edgemon were shareholders of Four A,[2] a Subchapter S corporation that, until February 1991, engaged in the business of underground coal mining and operated as a contract miner. App. 52a. Four A ceased mining operations in February 1991. App. 52a. Although Four A was no longer in operation after 1991, Petitioners were shareholders of Four A at all times during 1993, and each Petitioner owned 25% of Four A's outstanding shares. App. 49a. On January 1, 1993, each Petitioner had a zero basis in the stock and debt of Four A, as well as suspended losses of $189,779 from prior years

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1. Section references herein are to the Internal Revenue Code, unless otherwise noted.

2. Petitioners Salvador A. Gaudiano, Randy C. Edgemon, Larry A. Asher, and Gary D. Asher were the sole shareholders of Four A in 1991. Petitioners Kathleen M. Gaudiano and Kathleen R. Edgemon are named Petitioners solely by reason of their filing joint income tax returns with their spouses and are referred to throughout this Petition as a single Petitioner with their spouses.

pursuant to § 1366(d)(2). App. 50a. During 1993 each Petitioner invested $119,000 in Four A, thereby increasing basis in each shareholder's Four A stock by $119,000. App. 50a.

On December 3, 1993, Four A filed for protection under Chapter 7 of the Bankruptcy Code and was insolvent within the meaning of § 108(d)(3). App. 50a. After declaring bankruptcy, Four A's shares became worthless within the meaning of § 165(g), and in 1993, each Petitioner initially reported a capital loss of $157,066 from the disposition of his Four A stock. App. 50a-51a. As a result of the bankruptcy, however, Four A realized COD income of $1,289,048 within the meaning of 26 U.S.C. §§ 108 and 61(a)(12). App. 50a. Accordingly, the Petitioners increased their respective basis in Four A's debt by $322,262, representing a 25% share of such COD income. App. 50a. Each Petitioner then used such increase in basis to deduct $51,383 in ordinary losses, $68,752 in § 1231 losses for tax year 1993, and $189,779 in suspended losses from prior tax years. App. 50a.

In his deficiency notices, the Commissioner disallowed the Petitioners' deductions, asserting that a basis increase was unavailable under the relevant statutes. App. 51a.

II. Proceedings in the United States Tax Court

The Petitioners timely petitioned the United States Tax Court to review the proposed deficiencies. The Tax Court's jurisdiction arose under 26 U.S.C. §§ 6213, 6214, and 7442. The Tax Court entered its decisions upholding the Commissioner on January 12, 1999.

III. Proceedings in the United States Court of Appeals for the Sixth Circuit

Petitioners timely filed notices of appeal from the United States Tax Court decisions. The United States Court of Appeals for the Sixth Circuit, which had jurisdiction under 26 U.S.C. § 7482, affirmed the Tax Court's decisions after determining that the Petitioners' suspended and ordinary losses for tax year 1993 were offset at the corporate level by the COD income realized by Four A. App. 23a. Despite 26 U.S.C. § 108(b)(4)(A)'s requirement that "reductions [in tax attributes] shall be made after the determination of the tax imposed . . . for the taxable year of the discharge," the court of appeals determined that net operating losses (which include shareholder suspended losses) should have been reduced in the year of discharge in the amount of the COD income. App. 23a. The appeals court concluded that shareholder basis would increase only by the amount of COD income not offset by suspended losses. App. 24a.

REASONS FOR GRANTING THE WRIT

I. The Court Already Has Accepted for Review the Question Presented in This Appeal

On May 1, 2000, this Court granted a petition for writ of certiorari in a case presenting the same question presented in this case, that is, whether, in conflict with the holding of *United States v. Farley*, 202 F.3d 198 (3d Cir. 2000), *petition for cert. filed*, 68 U.S.L.W. 3670 (Apr. 17, 2000) (No. 99-1675), the court of appeals below incorrectly determined that tax attributes subject to reduction under § 108(b)(2) must be reduced in the year that an insolvent subchapter S corporation realizes COD income,

despite 26 U.S.C. § 108(b)(4)(A)'s requirement that tax attribute reduction "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge [of COD income]." *See Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), *cert. granted*, 68 U.S.L.W. 3497, 3680, 3684 (U.S. May 1, 2000) (No. 99-1295). *Gitlitz* is set for argument before this Court on October 2, 2000. Because the Court's decision in *Gitlitz* will be dispositive of the issue presented in this appeal, the petition in this case should be held and disposed of as appropriate in light of the Court's disposition of *Gitlitz*.

II. The United States Circuit Courts of Appeals Are Divided on the Issue

The U.S. Circuit Courts of Appeals are divided on the effect of excluded COD income on S corporation shareholder basis and the timing of attribute reduction under § 108. Moreover, the federal courts that have reached the same result have employed inconsistent statutory interpretations to arrive at their conclusions. The Tax Court held for the Commissioner and disallowed both the deduction of suspended losses and increase in basis in *Nelson v. Commissioner*, 110 T.C. 114 (1998), on grounds subsequently rejected by the Tenth Circuit in *Gitlitz*, 182 F.3d at 1148, and *Nelson v. Commissioner*, 182 F.3d 1152, 1152-53 (10th Cir. 1999). The Tenth Circuit in *Gitlitz* and *Nelson*, while affirming the decisions of the Tax Court, based its decision on the belief that Congress did not intend to confer a "windfall" upon the taxpayers, notwithstanding statutory language that permits both an increase in basis and the deduction of suspended losses. *Gitlitz*, 182 F.3d at 1148. The Third Circuit in *Farley* rejected the reasoning of both

the Tax Court and the Tenth Circuit, 202 F.3d 198, 205 n.4, 208, and held for the taxpayers, allowing the deduction of suspended losses and increase in basis. *Farley*, 202 F.3d at 205-06. The Seventh Circuit rejected the reasoning set forth in *Farley* in favor of preventing a perceived taxpayer windfall. *Witzel v. Commissioner*, 200 F.3d 496, 497 (7th Cir. 2000). The Eleventh Circuit in *Pugh* has rejected the reasoning of the Tax Court and the Tenth Circuit and determined that COD income passes through to adjust shareholder basis. *Pugh v. Commissioner*, 213 F.3d 1324, 1328 (11th Cir. 2000), *petition for cert. filed*, 69 U.S.L.W. 3156 (U.S. Aug 14, 2000) (No. 00-242). In contrast to the holdings of *Farley*, *Nelson*, and *Gitlitz*, the Sixth Circuit in the case below adopted the Seventh Circuit's reasoning in *Witzel* and determined that COD income is an "item of income" that passes through an insolvent S corporation to adjust shareholder basis, but only by the amount not "offset" by § 108(b)(2) attribute reduction. *See Gaudiano v. Commissioner*, 216 F.3d 524, 534-35 (6th Cir. 2000).

The conflict among the U.S. Circuit Courts of Appeals affects a significant number of insolvent S corporations and their shareholders. Accordingly, a decision by this Court is necessary to resolve the conflict among the circuits and to assure the uniform application of the federal tax laws.

III. The Sixth Circuit's Holding That Attribute Reduction Occurs in the Year of Discharge and Reduces the Amount of COD Income Pass Through Is Contrary to the Plain Language of the Controlling Statutes

Although the Sixth Circuit correctly found that Petitioners were entitled to an increase in basis as a result of Four A's discharge of indebtedness, the appeals court erred in holding that attribute reduction under § 108(b)(2) occurs in the year of discharge and that the amount of COD income that passes through to increase S corporation shareholder basis is reduced by the amount of attribute reduction. To aid the Court's understanding of these issues, we briefly explain why Petitioners were entitled to an increase in basis by the entire amount of COD income in the year of discharge. We then demonstrate that Petitioners were entitled to deduct current and previously suspended losses against the increase in shareholder basis resulting from Four A's realization of excluded COD income and that § 108(b)(2) requires attribute reduction to occur in the year following the year of discharge.

A. All COD Income Realized by an S Corporation and Excluded from Income under § 108 Is an "Item of Income" That Increases Shareholder Basis Pursuant to §§ 1366 and 1367

Congress enacted Subchapter S of the Code to minimize the effect of federal income taxation on the choice of business organization form and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both corporate and shareholder levels. Although an ordinary corporation's income is taxed twice — once when the corporation earns

income and again when shareholders receive corporate distributions — an S corporation's income generally is taxed at the shareholder level only, and the S corporation itself is rarely, if ever, taxed. § 1363(a). Income, expenses, and other tax-related items of an S corporation are passed through to its individual shareholders. § 1366. If an item of income (taxable or nontaxable) is "taken into account" under § 1366, the shareholder's basis in the stock of the S corporation is increased by that amount. § 1367(a). This taxation concept is known as "pass-through" taxation, and it is the linchpin of the S corporation business form.

Section 61(a)(12) generally requires the inclusion of COD income in gross income. When a taxpayer is insolvent, however, COD income is excluded from gross income. § 108(a)(1)(B). The determination of insolvency is made "at the corporate level." § 108(d)(7)(A). Although COD income is excluded from the gross income of an insolvent S corporation, the COD income amount nonetheless must be used as a measure to reduce certain tax attributes. § 108(b)(1). Those attributes include net operating losses (NOLs), certain business credits, capital loss carryovers, basis of the taxpayer's property, and foreign tax credit carryovers. § 108(b)(2)(A)-(G). Because S corporations do not have NOLs, § 108 contains a special rule that treats shareholder suspended losses as NOLs for purposes of attribute reduction. § 108(d)(7)(B).[3]

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3. Under the Subchapter S tax regime, losses of an S corporation pass through to the shareholders and may be deducted to the extent of the shareholders' basis in stock or debt. § 1366(d)(1). In the event the amount of losses exceed a shareholder's basis, the losses are "suspended" and carried forward indefinitely into future years. § 1366(d)(2). Suspended losses can be deducted in any

(Cont'd)

Under the pass-through rules applicable to S corporations, S corporation shareholders must take into account the S corporation's "items of income (including tax-exempt income)" if the corporate income could affect shareholder tax liability. § 1366(a)(1)(A). Section 1366(a)(1)(A) includes the term "tax-exempt income" in recognition that a basis increase or decrease would affect shareholder tax liability. Therefore, the term "items of income (including tax-exempt income)" must encompass both recognized income (i.e., income that is received and included in gross income) and realized income (i.e., income that is received, but excluded from taxable gross income). Section 1366's legislative history indicates that Congress understood that tax-exempt income realized by an S corporation would pass through to S corporation shareholders, and that although the tax-exempt income would not be included in a shareholder's taxable gross income, the income would increase the shareholder's basis in his or her S corporation stock: "Tax-exempt interest will pass through to the shareholders as such and will increase the shareholders' basis in their subchapter S stock," and "[B]oth taxable and nontaxable income . . . will serve, respectively, to increase and decrease a subchapter S shareholder's basis in the stock of the corporation." S. Rep. No. 97-640, §§ III(C)(2)(D) & (3) (1982). Further, four U.S. Circuit Courts of Appeals, including the court below, have concluded that an S corporation's excluded COD income is an "item of income" within the meaning of

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(Cont'd)
subsequent year to the extent a shareholder later has sufficient basis to utilize such losses. Section 108(d)(7)(B) effectively treats an S corporation shareholder's suspended losses as a corporate NOL solely for the purpose of applying the attribute reduction rules to S corporations.

§ 1366. *Gaudiano*, 216 F.3d at 534; *Pugh*, 213 F.3d 1329-31; *Farley*, 202 F.3d at 206; *Witzel*, 200 F.3d at 498. Accordingly, the benefit claimed by the Petitioners in this case — an increase in shareholder basis that permits the deduction of suspended losses — is expressly allowed by the language of the statutes.

B. The Plain Language of the Controlling Statutes Requires That Attribute Reduction Occur in the Year Following the Year of Discharge

In the case below, the Sixth Circuit agreed that, absent the application of § 108, the basis of Petitioners' stock was increased by the amount of Four A's COD income pursuant to § 1366(a). *Gaudiano*, 216 F.3d at 534. The court held, however, that under § 108(b)(4)(B) an insolvent S corporation must first calculate its NOL for the year of discharge and its suspended losses (both types of losses being considered NOLs under § 108(d)(7)(B)) and then reduce those tax attributes *in the year of discharge* by the amount of realized COD income. *Id.* at 534. The court also determined that COD income passes through to shareholders under § 1366(a) only to the extent it exceeds the amount of tax attributes reduced in the year of discharge. *Id.* at 535. In other words, the amount of COD income that passes through under § 1366(a) is somehow "offset" against the amount of NOL tax attributes.

In reaching its decision, the Sixth Circuit failed to follow § 108(b)(4)(A)'s instruction that "[t]he reductions [in tax attributes] shall be made after the determination of the tax imposed . . . for the taxable year of the discharge." Indeed, in order to reach its result, the appeals court took a position squarely at odds with the statutory rules governing the timing

of attribute reduction, finding that NOL attribute reduction under § 108(b)(2)(A) occurs during — rather than after — the taxable year of discharge. *Cf. Gaudiano*, 216 F.3d at 534 ("While § 108(b)(4)(A) provides that the reduction in attributes shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge, it does not preclude the reduction of certain attributes in the year of discharge."). As justification for its holding that "certain" attributes must be reduced in the year of discharge, the Sixth Circuit mistakenly viewed § 108(b)(4)(B) as creating an exception to the attribute reduction timing rule in § 108(b)(4)(A). *Id.*; *see* § 108(b)(4)(B) ("The reductions described in [§ 108(b)(2)(A) or (C)] shall be made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.").

The Sixth Circuit's interpretation of § 108(b)(4)(B) is erroneous. Section 108(b)(4)(B) does not create an exception to the timing rule of § 108(b)(4)(A), but instead describes the *order* in which certain tax attributes are reduced. Although S corporation NOLs (i.e., suspended losses) carry over indefinitely,[4] § 108 applies equally to entities whose carryovers are not of indefinite duration, including C corporations. Because a C corporation's NOLs are lost after a certain period of time,[5] § 108(b)(4)(B) provides an

4. Section 1366(d)(2) ("Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.").

5. Section 172(b)(1)(A)(ii) ("Except as otherwise provided in this paragraph, a net operating loss for any taxable year . . . shall be a net operating loss carryover to each of the 20 taxable years following the taxable year of the loss.").

order in which tax attribute reduction will occur. The statute provides that a taxpayer's NOLs for the year of discharge will be reduced first, with the taxpayer's NOL carryovers then being reduced in the order which they arose. Thus, a taxpayer who receives COD income in 1993, has an NOL in 1993, and has NOL carryovers for 1990, 1991, and 1992, will first apply such COD income amount to reduce the 1993 NOL. The remaining COD income amount then will be applied to reduce NOL carryovers from 1990 forward. The statute's legislative history confirms this interpretation:

> The reduction in each category of carryovers is made in the order of taxable years in which the items would be used, with the order determined as if the debt discharge were not excluded from income. . . . Thus in the case of net operating losses or capital losses, the debt discharge amount first reduces the current year's loss and then reduces the loss carryovers in the order in which they arose. The investment credits are reduced on a FIFO basis, and the other credit carryovers also are reduced in the order they would be used against taxable income. *These reductions are made after the computation of the current year's tax.*

S. Rep. No. 96-1035, § II(A), at n.14 (1980) (emphasis added). Accordingly, contrary to the Sixth Circuit's opinion, Congress did not intend § 108(b)(4)(B) to require attribute reduction to occur in the year of discharge or to qualify the timing rules set forth in § 108(b)(4)(A). Rather, § 108(b)(4)(B) and § 108(b)(4)(A) address separate issues: § 108(b)(4)(B) provides the *order* in which certain tax attributes are reduced, and § 108(b)(4)(A) addresses

when tax attribute reduction will occur. Thus, the Sixth Circuit's reliance on § 108(b)(4)(B) for statutory authority that NOL tax attribute reduction takes place in the year of discharge is totally misplaced. The Sixth Circuit provides no explanation or rationale as to why Congress would have created a special rule for NOL attribute reduction in such an obfuscated manner. Moreover, any such exception would be inconsistent with the provisions of § 108(b)(5), which allow taxpayers to opt out of the ordering sequence of § 108(b)(2) by electing to reduce basis in depreciable property under § 1017. Reduction of basis under § 1017 clearly takes place in the year following the year of discharge. *See* § 1017(a). Thus, under the Sixth Circuit's holding, a taxpayer could elect under § 108(b)(5) not only to opt out of the ordering sequence of § 108(b)(2), but also to avoid any attribute reduction in the year of discharge. If such an election were made, and the S corporation had sufficient basis in its depreciable assets to absorb the entire attribute reduction amount, there would be no reduction of the tax attributes in the year of discharge and the S corporation's shareholders would be able to deduct suspended losses in that year. There is no rationale for creating a rule that would operate in such a manner.

Because "the determination of the tax imposed . . . for the taxable year of the discharge," cannot be performed until the tax year is complete, § 108(b)(4)(A), the tax attribute reduction required by §§ 108(b)(1) and (2) must take place in the tax year following the tax year in which an insolvent S corporation realizes COD income. To this end, the *Farley* court held that the plain language of § 108(b)(4)(A) mandates the following result:

The language in section 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year *following* the year of the discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straight-forward. . . . Discharge of indebtedness income excluded from gross income under section 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to section 1366(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholder's S corporation stock pursuant to section 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally, the tax attribute reduction required by section 108(b) takes place on the first day of the tax year *following* the year of the discharge of indebtedness, as mandated by section 108(b)(4)(A).

We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this chapter for the taxable year of the discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by section 108(a), passes through to the shareholders, increases the shareholder[s'] basis in their

> S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under section 1366(d)(1).

Farley, 202 F.3d 205-06 (emphasis added).

Although the Sixth Circuit acknowledged in the case below that "this is a very close call," 216 F.3d at 534, its holding ignores the plain language of § 108(b)(4)(A) and conflicts with the holdings of other courts that attribute reduction does not occur until after the tax liability for the year of discharge is computed. *See Farley*, 202 F.3d at 205-06; *Hogue v. United States*, No. 99-302-KI, 2000 WL 2651, at *3 (D. Or. Jan. 3, 2000); *CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 T.C. 398, 414-15 (1994) (considering application of attribute reduction rules in consolidated return setting and determining that tax attribute reduction under § 108(b)(4) does not occur "until the next taxable year"), *aff'd per curiam*, 62 F.3d 136 (5th Cir. 1995) (adopting Tax Court opinion).

C. The Sixth Circuit Incorrectly Presumed That a Shareholder's Basis in S Corporation Stock Increases Only by the Amount of COD Income Not Offset by Suspended Losses

The Sixth Circuit agreed with Petitioners that § 1366(a) requires that COD income realized by an insolvent S corporation pass through to increase shareholder basis. 216 F.3d at 533. Relying on *Witzel*, however, the court of appeals presumed that shareholder basis is increased only by the amount of COD income not "eliminated" through the tax attribute reduction process. *Id.* at 533 n.8 ("Presumably, the shareholder's basis in his S corporation stock would only

increase by the amount of the COD income which was not offset by the existing suspended losses."); *id.* at 535 ("If any COD income remains after losses and suspended losses are deducted, that income may flow through to the shareholders. . . ."). Thus, according to the Sixth Circuit, if an insolvent S corporation receives $1,000,000 in COD income and the sole shareholder has $0 basis and $1,000,000 in suspended losses, all of the shareholder's suspended losses will be eliminated through the attribute reduction. Further, none of the COD income will pass through to adjust shareholder basis, because the COD income is somehow absorbed under § 108's attribute reduction rules.

Nothing in *Witzel* or § 108 supports the Sixth Circuit's presumption. An insolvent S corporation's COD income amount simply is a measurement used to determine the amount of reduction in tax attributes. This type of measurement is a common method for making correlative adjustments under the Internal Revenue Code. For example, § 50(c) provides that "if [an investment] credit is determined . . . the basis of [investment credit] property shall be reduced by the amount of the credit. . . ." Thus, although the amount of the credit is used to measure the basis reduction in the investment credit property, the investment credit itself does not simply disappear. Likewise, COD income is not "absorbed" or "eliminated" through the tax attribute reduction calculation, and nothing in § 108 requires such "absorption" for pass-through purposes. As noted in *Witzel*, the tax attribute reduction mechanism of § 108(b)(2) and the basis adjustment rules of § 1367 function independently of each other. 200 F.3d at 498. Section 108(b)(2)'s tax attribute reduction mechanism provides for the reduction of past and current losses and credits *at the corporate level*. §§ 108(b)(2) & 108(d)(7)(A);

Witzel, 200 F.3d at 498. The elimination of past and current losses and credits at the corporate level does not affect the calculation of basis *at the shareholder level*, which is governed by §§ 1366 and 1367. *Pugh*, 213 F.3d at 1327 ("Nothing in § 108 expressly marks COD income for special bottlenecking — that is, that COD income 'at the corporate level' means 'at the corporate level and no further.' To see whether COD income passes through to S corporation shareholders, we must inquire whether COD income is an 'item of income . . . [under I.R.C. § 1366(a)(1)].' "). Section 1366 provides that both taxable and tax-exempt income, including COD income, are passed through to adjust shareholder basis, *Pugh*, 213 F.3d at 1329-30 [6]; *Witzel*, 200 F.3d at 498, and § 1367 requires a dollar for dollar increase in basis by the amount of passed-through corporate income. *See* § 1367(a)(1)(A) ("The basis of each shareholder's stock in an S corporation shall be increased for any period by . . . the items of income described in subparagraph (A) of section 1366(a)(1). . . ."); § 1366 ("In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . there shall be taken into account the shareholder's pro rata share of the corporation's . . . items of income (including tax-exempt income). . . ."). Because § 108(b)(2)'s mechanism for attribute reduction at the corporate level operates independently of the pass-through rules of §§ 1366 and 1367, reduction of an S corporation's tax attributes has no effect on shareholder basis.

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6. Because the taxpayer in *Pugh* did not have suspended losses, the *Pugh* court did not reach the question of whether the amount of COD income that passes through is offset by the amount of tax attributes reduced pursuant to § 108(b)(2).

IV. The Commissioner's Position and the Sixth Circuit's Decision Conflicts with the Standards of Statutory Interpretation Established by This Court

Subchapter S basis rules have been in place since 1982, and Congress enacted § 108(d)(7) in 1984. It is only recently that the Commissioner has attempted to construe the Code in a manner precluding both a basis adjustment and elimination of NOLs in the year of discharge when an S corporation realizes COD income.[7] The Commissioner's and the court of appeals' strained construction of §§ 108, 1366, and 1367 is an attempt to legislate a certain tax result through the judicial process. However, it is Congress, not the Commissioner, that legislates. U.S. Const. art. 1, § 1; *Hanover Bank v. Commissioner*, 369 U.S. 672, 687 (1962). ("[W]e are not at liberty, notwithstanding the apparent tax-saving windfall bestowed upon taxpayers, to add to or alter the words employed to effect a purpose which does not appear on the face of the statute.") The *Nelson* opinion reveals that the Tax Court was more concerned with avoiding what it perceived to be an unintended tax benefit than with applying the statute as written:

> In light of the relatively sparse legislative history that bears on the issue before us, we must construe what we can to form a proper perspective and provide a definitive answer to this anomalous situation. Here, petitioner has not borne an

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7. *Compare Witzel v. Commissioner*, 77 T.C.M. (CCH) 1487 (1999), *Pugh v. Commissioner*, 77 T.C.M. (CCH) 1367 (1999), *Cronin v. Commissioner*, 77 T.C.M. (CCH) 1293 (1999), and *Gaudiano v. Commissioner*, 76 T.C.M. (CCH) 858 (1998), *with Winn v. Commissioner*, 73 T.C.M. (CCH) 3167 (1997), *withdrawn*, 75 T.C.M. (CCH) 1840 (1998).

> economic cost. On the contrary, it would appear that the economic cost was to others, the creditors of the corporation. Nor has petitioner made an economic outlay. Section 108 allows an insolvent S corporation to receive COD income sheltered from immediate taxation to its shareholders. To permit petitioner to increase basis in the stock of the corporation on account of such tax-deferred income would produce a windfall to him.
>
> . . . .
>
> Thus, we decline to adopt petitioner's construction which, essentially, grants him an unwarranted benefit in addition to the exclusion from gross income for an insolvent S corporation.

110 T.C. at 128-29; *see also Witzel*, 200 F.3d at 497 ("The government's interpretation is not inevitable. . . . [T]he interpretative question could be resolved either way; but in these circumstances of dubiety the sensible result — denying the taxpayers the double windfall — seems to us the preferable one."). Based on its reliance on *Witzel*, it appears that the Sixth Circuit was similarly swayed.

Regardless of the Commissioner's and the courts' view of what correct tax policy (or even the result in this case) should be, the Commissioner and the courts are obligated to follow the Code as written, and if a statute confers a benefit, the courts must uphold it:

> [T]he rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the

> Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall.

Lewyt Corp. v. Commissioner, 349 U.S. 237, 240 (1955) (citation omitted); *see Hanover Bank*, 369 U.S. at 688 & n.23 ("[T]he Government now urges this Court to do what the legislative branch of the Government failed to do or elected not to do. . . . 'Granting the government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for the application of the Congressional thumb, not the court's.' ") (quoting *Fabreeka Prods. Co. v. Commissioner*, 294 F.2d 876, 879 (1st Cir. 1961)).

Although the courts addressing this issue have decried taxpayer "windfalls," *see Witzel*, 200 F.3d at 497; *Gitlitz*, 182 F.3d at 1150, and the *Nelson* court found it "anomalous" for taxpayers to receive an increase in basis for nontaxable COD income in which the taxpayers have no economic investment, 110 T.C. at 128, a certain tax result cannot drive the statutory inquiry, and the courts cannot revise the Internal Revenue Code to reach what the Commissioner portrays as better tax policy. *See Hanover Bank*, 369 U.S. at 687-88; *Lewyt*, 349 U.S. at 240; *Transco Exploration Co. v. Commissioner*, 949 F.2d 837, 841 (5th Cir. 1992). Federal courts simply do not have the authority to revise and distort the Code in order to reach what the Commissioner portrays as better tax policy.

See Abdalla v. Commissioner, 647 F.2d 487, 503 (5th Cir. 1981); *International Trading Co. v. Commissioner*, 484 F.2d 707, 711 (7th Cir. 1973). In *Transco Exploration Co.*, 949 F.2d at 841, the Fifth Circuit clearly articulated this Court's longstanding requirement that courts construe the Code as written:

> Indeed, the Supreme Court stated in [*Hanover Bank*] that "we are not at liberty, notwithstanding the apparent tax-saving windfall bestowed upon taxpayers, to add to or alter the words employed to effect a purpose which does not appear on the face of the statute." 369 U.S. at 387, 82 S. Ct. at 1089. Similarly, the Court has explained that "where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall." *Lewyt Corp. v. Commissioner of Internal Revenue*, 349 U.S. 237, 240, 75 S. Ct. 736, 739, 99 L. Ed. 1029 (1955). Therefore, although we should try to avoid double tax benefits, courts must leave them standing if the Code positively requires this outcome.

In this case, the Code requires the full basis increase claimed by Petitioners. Although the basis increase benefits taxpayers under certain circumstances, perhaps unintentionally, the proper course of action is to petition Congress to change and clarify the law, not legislate through the judicial process.

CONCLUSION

The Petition for Writ of Certiorari should be held and disposed of as appropriate in light of the Court's disposition of *Gitlitz*.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT DATED, DECIDED AND FILED JUNE 8, 2000

United States Court of Appeals,
Sixth Circuit.

Salvador A. GAUDIANO, et al.,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

No. 99-1294.

Argued Dec. 17, 1999.
Decided and Filed June 8, 2000.

* * *

Before: BOGGS and NORRIS, Circuit Judges; NUGENT, District Judge.*

OPINION

NUGENT, District Judge.

The Commissioner of Internal Revenue (hereinafter the "Commissioner") assessed tax deficiencies against Salvador A.

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* The Honorable Donald C. Nugent, United States District Judge for the Northern District of Ohio, sitting by designation.

and Kathleen M. Gaudiano, Randy C. and Kathleen R. Edgemon, Gary D. Asher, and Larry A. Asher (collectively the "Taxpayers") for the year 1993. The Commissioner determined that the Taxpayers had improperly utilized discharge of indebtedness income to increase their bases in the stock of their Subchapter S corporation Four A Coal Co.[1] Each Taxpayer then used the increase in basis to deduct certain losses. The Commissioner disallowed the deductions. In his answer to the Taxpayers' petitions in the Tax Court, the Commissioner asserted increased deficiencies against Taxpayers Gary Asher and Larry Asher for their pro rata share of a bad debt deduction taken by their Subchapter S corporation Appolo Fuels, Inc., for loans made to Four A Coal Co. After a trial, the United States Tax Court upheld all of the Commissioner's deficiency determinations. The Taxpayers filed this timely appeal.[2] We exercise jurisdiction pursuant to 26 U.S.C. § 7482(a)(1) and AFFIRM for the reasons stated below.

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1. Kathleen M. Gaudiano and Kathleen R. Edgemon were not shareholders in Four A Coal Co. They are parties to these actions only because they filed joint tax returns with their husbands.

2. The Taxpayers do not appeal the Tax Court's determination regarding the Taxpayers' claims for refund for their distributive shares of the increased § 1231 loss claimed by Four A in an amended Form 1120S which reported the amount realized on the sale of mining equipment as $145,430 instead of $445,000 as previously reported in 1993.

Appendix A

Procedural and Factual Background

I. Discharge of Indebtedness Income

During 1993, and relevant prior years, Taxpayers Salvador Gaudiano, Gary Asher, Larry Asher, and Randy Edgemon were each 25% shareholders of Four A Coal Co. (hereinafter "Four A"), a Kentucky corporation electing to be taxed under Subchapter S of the Internal Revenue Code (26 U.S.C. §§ 1361 through 1379). Until February of 1991, Four A engaged in the business of underground coal mining and operated as a contract miner for another Subchapter S corporation, Appolo Fuels, Inc. (hereinafter "Appolo"). Taxpayers Gary D. Asher and Larry A. Asher were 24% shareholders in Appolo.

In January, 1993, Four A filed for protection under Chapter 7 of the Bankruptcy Code and was insolvent within the meaning of 26 U.S.C. § 108(d)(3). As a result of the bankruptcy, Appolo wrote off as bad debt the loans it had made to Four A. Thus, Four A realized $1,289,048 in discharge of indebtedness income, also known as cancellation of debt income (hereinafter "COD" income). While gross income generally includes income from the discharge of indebtedness[3], § 108(a)(1)(B) provides an exclusion of discharge of indebtedness income from gross income when the taxpayer is insolvent. Pursuant to 26 U.S.C. § 108(d)(7)(A), the exclusion is determined at the S corporation level (not the shareholder level) in cases of discharge of S corporation indebtedness. The exclusion

3. See 26 U.S.C. § 61(a)(12).

applied to Four A's discharge of indebtedness income. Thus, Four A's discharge of indebtedness income was excluded from gross income because Four A was insolvent when the debt was discharged.

Relying on the pass through and basis adjustment provisions applicable to Subchapter S corporations in 26 U.S.C. §§ 1366 and 1367, the Taxpayers increased their respective bases in the stock of Four A by $322,262, representing a 25% share of the discharge of indebtedness income[4]. Each Taxpayer then used the increase in basis to deduct suspended losses from prior tax years as well as ordinary losses from 1993 which would not have been deductible without the increase in the shareholders' bases. Upon audit, the Commissioner determined that the Taxpayers were not entitled to increase their adjusted bases in the stock of Four A by their pro rata shares of the excluded discharge of indebtedness income. Therefore, the Commissioner denied the loss deductions claimed by the Taxpayers as a result of the upward basis adjustments and assessed the deficiencies

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4. 26 U.S.C. § 1366(a)(1) provides that, in determining an S corporation shareholder's tax liability, "there shall be taken into account the shareholder's pro rata share of the corporation's —

> (A) items of income (including tax-exempt income) . . . the separate treatment of which could affect the liability for tax of any shareholder. . . ."

26 U.S.C. § 1367(a)(1)(A) provides that "the basis of each shareholder's stock in an S corporation shall be increased . . . by . . . (A) the items of income described in subparagraph (A) of section 1366(a)(1)."

at issue here. Taxpayers filed Tax Court petitions contesting the deficiency determinations.

II. Disallowance of Appolo Bad Debt Deduction

Appolo is an S corporation which began as a surface mining operation but changed to a coal processing and coal sales company by 1988. Taxpayers Larry Asher and Gary Asher were 24% shareholders of Appolo. Appolo purchased coal from Four A. Between the years 1988 and 1991, Appolo advanced large sums of money to Four A. Four A ceased mining operations in February of 1991. In March, 1991, Price Waterhouse LLP audited Appolo's 1990 financial statements. During that audit Price Waterhouse questioned the collectibility of the Four A debt and raised the question of whether a bad debt reserve should be established on Appolo's books. Appolo, through its chief financial officer Taxpayer Salvadore Gaudiano, asserted that the debt was collectible and presented a repayment plan developed by the Four A shareholders to repay the debt to Appolo over eight years from equipment rental fees, the residual value of the Four A mining equipment, and Taxpayer loans to Four A.

Price Waterhouse reviewed the repayment plan and determined that the loans should have some sort of personal guarantee of the shareholders. Mr. Gaudiano and Price Waterhouse agreed that the Four A Taxpayers would execute guarantees to Appolo for the Four A debt and that Appolo would not be required to establish a reserve against the Four A debt. On or about May 13, 1991, the Taxpayers executed two guaranty agreements (collectively, the Guarantees). The first guaranty, which is titled "Continuing Guaranty", was

backdated to January of 1989. The Continuing Guaranty provides in relevant part:

> [Appolo] has from time to time loaned money to Four A on a demand basis, some of which loans remain outstanding. . . . [T]he guarantors desire to grant this Guaranty to Appolo as consideration for Appolo not demanding immediate payment of its existing loans to Four A, and as an inducement to Appolo to make future advances to Four A, without which Guaranty Appolo would not take such action; . . . Therefore, . . . in exchange for good and valuable consideration, the receipt and sufficiency of which all the Guarantors hereby acknowledge, the Guarantors do hereby absolutely, unconditionally and irrevocably guaranty to Appolo . . . [t]he repayment in full (without interest) of all loans and advances made by Appolo to Four A, including both those currently outstanding and those made in the future. . . .

(Joint Ex. 19-s, JA 356-58). The Continuing Guaranty further states: "Each of the Guarantors expressly agrees that neither the bankruptcy, insolvancy [sic], reorganization, liquidation, dissolution, death or disability of any or all of Four A and the other Guarantors shall diminish, impair, discharge or release, or otherwise affect, the obligations and liability of the Guarantor under this Guaranty. . . ." Id. at JA 357.

The second Guaranty, backdated to April 30, 1990, guarantees two loans from Appolo to Four A in the amounts

of $500,000 and $170,000. The Guaranty states that "the Guarantors have previously agreed to guarantee the First Note and the Guarantors desire to guarantee the Second Note as an inducement to Appolo to make the loan evidenced thereby, without which guarantee Appolo would not take such action". (Joint Ex. 20-t, JA 359). As in the Continuing Guaranty, the second Guaranty asserts that the Guaranty is provided in exchange for "good and valuable consideration, the receipt and sufficiency of which all the Guarantors hereby acknowledge" and that "neither the bankruptcy, insolvancy [sic], reorganization, liquidation, dissolution, death or disability of any or all of Four A and the other Guarantors shall diminish, impair, discharge or release, or otherwise affect, the obligations and liability of the Guarantor under this Guaranty". Id. at JA 360.

Four A filed a petition for relief under Chapter 7 of the Bankruptcy Code in December, 1993. At the time of its bankruptcy filing, Four A owed $1,106,000 to Appolo. Appolo determined that the Four A debt was "worthless" and deducted the $1,106,000 Four A debt as a business bad debt pursuant to 26 U.S.C. § 166(a) on its 1993 Form 1120S, U.S. Income Tax Return for an S Corporation. Appolo never demanded payment from Four A or any of its shareholders. Taxpayers Larry Asher and Gary Asher, as Appolo shareholders, each reported an ordinary loss of $80,246 on their individual 1993 tax returns based on their distributive shares of Appolo's bad debt write-off.

The Commissioner did not disallow the loss deductions claimed by the Ashers upon audit. Rather, in his answer in the Larry Asher case, and in an amendment to his answer in

the Gary Asher case, the Commissioner asserted that Appolo was not entitled to a bad debt deduction for the amounts owed by Four A because those debts were not worthless in 1993 in that the debts were guaranteed by the Four A shareholders who were financially able to make full payment on Four A's debts to Appolo. Consequently, the Commissioner requested that the Tax Court determine that the Ashers were liable for increased deficiencies for 1993.

The Ashers opposed the Commissioner's requests for increased deficiencies, contending that the Guarantees were not given in exchange for consideration, and thus, were not enforceable under Kentucky law. During a brief trial before the Tax Court, the Taxpayers offered testimony that they were told the Guarantees were for the auditors and that Appolo never demanded that the Guarantees be executed. Further, the Taxpayers testified that it was understood by Appolo and the Taxpayers that Appolo did not require and would never enforce the Guarantees; the Guarantees were executed solely to appease the Price Waterhouse auditor. The Taxpayers asserted that the Guarantees were given to the auditor and that no copies were kept by the Taxpayers or Appolo. Moreover, the Taxpayers contended that the consideration language in the Guarantees was merely form language added by Appolo's legal counsel John Stites which Appolo had not requested. Finally, the Taxpayers testified that Appolo had never promised to forbear from suing Four A on Four A's past debt.

The Tax Court held that Appolo was not entitled to a bad debt deduction for the amounts loaned to Four A; and thus, the Ashers were not entitled to the ordinary losses they

claimed as their distributive share of Appolo's deduction. The Tax Court's decision was based on its observation that the Guarantees appeared valid and enforceable on their faces. The Tax Court focused on the first Continuing Guaranty, which stated on its face that consideration was given to the Four A shareholders in that Appolo promised not to demand immediate payment on past loans to Four A and to make future loans to Four A. Noting that forbearance to sue is sufficient consideration to support a promise, the Tax Court found that the first Guaranty was supported by sufficient consideration and held that the Guaranty was valid and enforceable. In making this finding the Tax Court did not accept the self-serving testimony of the Taxpayers offered to prove that Appolo did not give consideration for the Guarantees. The Tax Court also found that the Taxpayers were financially able, both in 1993 and at the time of the trial, to satisfy Four A's debts to Appolo. Consequently, the Tax Court concluded that since the first Continuing Guaranty is enforceable, the debt was not worthless, regardless of whether the second Guaranty is enforceable.

Analysis

I. Pass Through Issue

The initial issue in this case raises a question of first impression in this Circuit. Whether the Taxpayers, as the shareholders of Four A, an S corporation, are entitled to increase their bases in the stock of Four A by their pro rata share of discharge of indebtedness income ("COD income") realized by Four A, but excluded by Four A pursuant to 26 U.S.C. § 108(a)?

Appendix A

There are no facts in dispute, thus the Tax Court's decision on this legal issue is a question of law that is reviewed de novo. Estate of Mueller v. Commissioner, 153 F.3d 302, 304 (6th Cir.1998).

A. The Tax Court Decision

The Tax Court held that the COD income that Four A excluded from gross income under § 108(a) is not a separately stated item of tax-exempt income for purposes of § 1366(a)(1)(A). Therefore, Taxpayers were not entitled to increase their bases in the Four A stock due to Four A's COD income. In reaching this decision, the Tax Court relied, with little discussion, on its reviewed decision in Nelson v. Commissioner, 110 T.C. 114, 1998 WL 66131 (1998), aff'd, 182 F.3d 1152 (10th Cir.1999).

In Nelson, the Tax Court held that a taxpayer was not entitled to increase the basis in his S corporation stock by his pro rata share of the insolvent corporations's COD income. The Nelson court set out the arguments as follows:

> The parties' dispute herein centers on the language in section 108(d)(7)(A). Specifically, the parties differ on the precise meaning of the phrase, "in the case of an S corporation, * * * [section 108] shall be applied at the corporate level." Sec. 108(d)(7)(A). [The Commissioner] argues that section 108(d)(7)(A) represents an adjustment and/or exception to the principles underlying the subchapter provisions that items of income realized or recognized at the corporate level are

passed through to the shareholders. On the other hand, [Taxpayer] contends that section 108(d)(7)(A) stands for the proposition that prior to the determination of an individual shareholder's income tax liability, the S corporation must be ascertained to be insolvent.

[The Taxpayer], in effect, argues that the result of the interaction between section 108(d)(7)(B) and (b)(2), as governed by section 108(b)(4), is to apply the attribute reduction rules of section 108(b)(2) at the shareholder level. Section 108(b)(4) states that the reduction in tax attributes will be made "after the determination of the tax imposed * * * for the taxable year of the discharge." (Emphasis added.) Next, [Taxpayer] points out that "suspended losses" under section 1366(d)(i)-(3) are deemed to be net operating losses. Sec. 108(b)(2). Such "suspended losses" are determined at the shareholder level. Sec. 1366(d)(1). Consequently, [Taxpayer] extrapolates that the reduction in tax attributes occurs on the shareholder level. Similarly, [Taxpayer] reasons that COD income excluded under section 108(a)(1) passes through to the shareholder, increases his or her stock basis, and thus affects his or her "suspended losses" under section 1366(d). According to [Taxpayer], all of this occurs at the shareholder level, prior to the reduction in tax attributes under section 108(b)(2).

> Accordingly, in order for [Taxpayer] to prevail in this matter, the COD income otherwise excluded from gross income must pass through the corporate form and be apportioned on a pro rata basis among the subchapter shareholders. We disagree with [Taxpayer]'s statutory approach with respect to the COD income exclusion provision because it is simply not plausible. In this instance, section 108(d)(7)(A) explicitly provides that the COD income exclusion operates, for purposes of the subchapter S regime, on the corporate level.

Nelson, 110 T.C. at 120-21. The court held that the literal language of § 108(d)(7)(A) provides that the reduction in tax attributes applies at the corporate level. Id. at 121. Further, § 1366(b) provides that the character of any item included under § 1366(a)(1)(A) is determined as if realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation. Thus, the court determined that construing § 1366(a)(1)(A) in combination with § 108(d)(7)(A) meant that COD income was precluded from recognition at the shareholder level and could not, therefore, increase the shareholder's basis. Id. at 122.

In addition, the Tax Court held that § 108(b)(4)(A), which states that the reduction of tax attributes occurs after the determination of the tax imposed for the taxable year of the discharge, requires the S corporation to reduce its tax attributes by the amount excluded from gross income at the end of the corporation's taxable year. Id. at 123. The court

rejected taxpayer's argument that the income was "tax exempt" and thus statutorily required to pass through to S corporation shareholders under § 1366(a)(1)(A). Instead, the court noted that the exclusion could be subject to taxation in the future, and therefore was not necessarily tax exempt on a permanent basis. Id. at 125. After reviewing the "relatively sparse legislative history," the court also observed that allowing taxpayer to increase his basis by using income for which the creditors, not taxpayer, had borne an economic cost would produce an unintended windfall for taxpayer. Id. at 127-28.

B. Decisions of other courts on the COD pass through issue.

In July 1999, the Tenth Circuit, the first circuit to rule on this issue, affirmed the Nelson decision for the reasons stated in Gitlitz v. Commissioner of Internal Revenue, 182 F.3d 1143 (10th Cir.1999). The Tenth Circuit determined that:

> The outcome of this case is ultimately determined by the timing of the pass-through. If the attribute reduction procedures precede the pass-through, the corporation's excluded discharge of indebtedness income is absorbed before it can pass through to shareholders and compel basis adjustments. Potential windfalls are thus avoided. If, on the other hand, attribute reduction takes place after the pass-through, the taxpayers' theory must prevail.

Id. at 1148. The court concluded that attribute reduction must precede the pass through. In reaching this conclusion the court reviewed § 108(d)(7)(B) which provides that, in administering the tax attribute reduction scheme, shareholder losses suspended pursuant to § 1366(d)(1) must be treated as net operating losses for purposes of § 108(b)(2)(A), "thereby precluding subchapter S corporation shareholders with carryover losses from enjoying the tax benefits of ordinary losses while simultaneously avoiding taxation on discharge of indebtedness income." Id. The Court interpreted § 108(d)(7)(B) as requiring that shareholder suspended losses be added to the corporation's annual net operating losses in applying the net operating loss tax attribute reduction. The court conceded that since a subchapter S corporation's losses are normally deductible only by its shareholders, the corporation itself is not permitted to take a net operating loss deduction. However, the court noted, "nothing in the Internal Revenue Code mandates that corporate net operating losses pass through immediately to shareholders. If pass through was immediate, shareholders could secure a windfall by (1) avoiding tax on corporate discharge of indebtedness income under § 108(a), and (2) employing the corporation's passed-through net operating losses to reduce their own non-corporate related gross income without having first decreased the net operating losses by the amount of the corporation's discharged debt." Id.

The Tenth Circuit concluded that "when § 108(a)'s discharge of indebtedness income exclusion is triggered, a shareholder's pro rata share of the corporation's net operating losses passes through to him only to the extent such losses are not absorbed by the shareholder's pro rata share of the

excluded canceled debt." Id. Further, should any debt discharge amount remain after the tax attributes are reduced, it is disregarded and has no tax consequences; it does not increase the shareholder's basis.[5]

Two other circuit courts and one district court have also recently addressed this issue and have come to different conclusions. In United States v. Farley, No. 99-3209, 202 F.3d 198, 2000 WL 72087 (3rd Cir. Jan.27, 2000), the taxpayers obtained refunds after adjusting the basis of their S corporation stock upward to account for excluded COD income. By increasing the basis of their stock, the taxpayers were able to deduct previously suspended losses. The Court noted that the key to unraveling the case was determining how sections 1366, 1367, and 108 interact. As in Gitlitz, the Third Circuit noted that the timing of the pass through, which is controlled by § 108(b)(4)(A), determines the outcome of the case. Unlike the Tenth Circuit in Gitlitz, the Third Circuit held that:

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5. The Tenth Circuit set out examples which show how their interpretation of the interplay between §§ 108 and 1366-1368 operates in practice. The steps which need to be taken in each calculation are: 1) corporation computes its COD income and sets this figure aside temporarily; 2) corporation calculates its net operating loss tax attribute (net operating loss + shareholder suspended losses); 3) corporation applies the excluded COD income to reduce its tax attributes. After these calculations are complete, if any COD income remains it is ignored and has no tax consequences. If any net operating losses or suspended losses remain, they flow through to the shareholder and, depending on his basis, may be used by him to offset his own gross income. 182 F.3d at 1150 n. 6.

> [t]he language in section 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year following the year of the discharge of indebtedness. The statutory language is straight forward. Discharge of indebtedness income, considered income under section 61(a)(12), is excluded from gross income pursuant to section 108(a)(1)(B) if, as in this case, the S corporation is insolvent. This solvency determination is made at the corporate level rather than the individual shareholder level pursuant to section 108(d)(7)(A). Discharge of indebtedness income excluded from gross income under section 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to section 1366(a)(1)(A). Upon passing through to the S corporation's shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholder' S corporation stock pursuant to section 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally, the tax attribute reduction required by section 108(b) takes place on the first day of the tax year following the year of the discharge of indebtedness, as mandated by section 108(b)(4)(A).

Farley, 202 F.3d at 205. Accordingly, the Third Circuit determined that the taxpayers in Farley were entitled not only to increase the basis of their S corporation stock but also to take deductions for their current and suspended losses. Id.

Similarly, in Hogue v. United States, No. 99-302-KI, 2000 WL 2651 (D.Or. Jan.3, 2000), the court noted that § 108 is silent with respect to whether COD income passes through to S corporation shareholders. The court determined that once COD income is excluded from gross income pursuant to § 108(a)(1), it is treated as tax-exempt income pursuant to § 1366(a)(1) and is passed through to S corporation shareholders under that section. Pursuant to § 108(b)(2), the amount of COD income excluded from gross income is applied to reduce tax attributes. That reduction of tax attributes is made after the determination of the tax imposed by this chapter for the taxable year of the discharge. § 108(b)(4)(A). Thus, the court concluded that COD income passes through to S corporation shareholders in the year that the debt is discharged and the tax attributes are decreased in the year following the discharge because the determination of the tax imposed for the tax year in which the discharge occurred cannot take place until that tax year ends. Id. at *2-3. As a result, the S corporation shareholders in Hogue were allowed to increase shareholder basis in the year of the discharge and claim suspended losses against the increased basis. The attribute reduction mandated by § 108(b)(2) would occur in the year following the year of discharge. The court, noting that the Tenth Circuit's decision in Gitlitz was driven by the court's desire to avoid allowing the taxpayers to realize a windfall, stated that "[t]he Internal Revenue Code is too complicated for courts to strain against the language in an effort to achieve particular results." Id. at * 3.

Chief Judge Posner, writing for the Seventh Circuit, addressed this issue in Witzel v. Commissioner of Internal Revenue, 200 F.3d 496 (7th Cir.2000), and settled on a result

somewhere in the middle between the Tenth Circuit's position in Gitlitz and the positions of the Third Circuit in Farley and the District Court of Oregon in Hogue. The Seventh Circuit noted that while the "at the corporate level" language of § 108(d)(7)(A) was not susceptible to conclusive interpretation, "[i]f (b) [the subsection that reduces tax attributes by the amount of the excluded COD income] is to be applied at the corporate level, the implication, as the government argues, is that the excluded income must be set off against the suspended losses and the latter reduced accordingly." Id. at 503-04. Thus, the Court held "that section 108(d)(7)(A) requires that COD income of a subchapter S corporation be offset against any existing suspended losses arising from the operation of the corporation." Id. at 506. Thus, the taxpayer in Witzel was forbidden to deduct his existing suspended losses because they were offset at the corporate level by the amount of his corporation's COD income.[6] The Seventh Circuit noted that resolving the interpretive question in this way, which denies the taxpayers the double windfall, seemed to be preferable. Id. at 504. While Judge Posner did not specifically address the timing of the attribute reduction as set forth in § 108(b)(4), his holding indicates that he sided with the Gitlitz Court in finding that attribute reduction precedes pass through.

However, in contrast to Gitlitz, Judge Posner determined that COD income passes through to the shareholder pursuant to § 1366(a)(1)(A), which explicitly includes tax exempt income, and increases the basis of the shareholder's stock

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6. Mr. Witzel was the sole shareholder of an S corporation with $5.4 million of COD income and suspended losses of almost $3 million.

pursuant to § 1367. The Court was unpersuaded by the Tax Court's conclusion that COD income is merely tax deferred, not really tax exempt, noting that there could be occasions when COD income is truly tax exempt as opposed to merely tax deferred. In any event, Judge Posner noted that § 1366 is not limited to tax-exempt income, so even if COD income really was not tax exempt it would not take it out of § 1366.[7] Thus, while the taxpayer cannot use his increased basis to deduct existing suspended losses (because in Witzel those losses were completely offset by the amount of the COD income), the increased basis may enable the taxpayer to deduct future losses.[8] Id. at 498.

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7. The court noted a recent Treasury Regulation which supports the Commissioner's and the Tax Court's interpretation of § 1366, but declined to follow the regulation since it is only applicable to tax years beginning on or after August 18, 1998. The regulation states " 'Tax-exempt income' does not include income from discharge of indebtedness excluded from income under section 108 because such income is not permanently excludible from income in all circumstances in which section 108 applies." Treas. Reg. § 1.1366-1(a)(2)(viii), 64 Fed.Reg. 71641, 71643 (Dec. 22, 1999). Similarly, this regulation does not apply here because the tax year at issue is 1993.

8. Presumably, the shareholder's basis in his S corporation stock would only increase by the amount of the COD income which was not offset by the existing suspended losses. Thus, the S corporation had $5.4 million in excluded COD income which was offset by approximately $3 million in existing suspended losses leaving approximately $2.4 million in COD income to pass through to the shareholder to increase the shareholder's basis.

Appendix A

C. The Parties' Arguments

The parties in this case raise the same arguments made by the parties in Gitlitz, Farley, Witzel, and Hogue. The Commissioner argues that the only reasonable interpretation of § 108 is that COD income is recognized only at the corporate level, does not pass through to the shareholder, does not raise the shareholder's basis and instead eliminates suspended losses at the corporate level. Taxpayers argue that § 108(d)(7)(A)-(C) does not override or vary the general S corporation pass through and basis provisions set forth in §§ 1366 and 1367, nor does § 108(d)(7)(A) preclude pass through of COD income under § 1366(a)(1)(A).

As the conflicting decisions of the other courts which have analyzed this issue demonstrate, interpreting the Internal Revenue Code is about as easy as swimming through mud. The sections at issue, 108, 1366, and 1367, while seemingly clear on their faces, become muddy when they are applied in conjunction with each other.

The analysis begins with § 108(a)(1)(B) which provides that gross income does not include any amount which would be includible in gross income by reason of the discharge of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. In this case the parties agree that Four A was insolvent at the time that its debt to Appolo (approximately $2 million) was discharged. The amount excluded from gross income under § 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent. § 108(a)(3). Further, the amount of COD income excluded under § 108(a)(1)(B) shall be applied to reduce the tax

attributes of the taxpayer in the order listed in § 108(b)(2) [Net operating loss, general business credit, minimum tax credit, capital loss carryovers, basis reduction, Passive activity loss and credit carryovers, and foreign tax credit carryovers]. § 108(b)(1). Section 108(b)(4) provides that the reductions described in § 108(b)(2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge. Section 108(d)(7) contains special rules for S corporations. Section 108(d)(7)(A) provides that in the case of an S corporation, subsections (a) [exclusion of COD income if taxpayer is insolvent or is in Title 11], (b) [reduction of tax attributes] and (g) [qualified farm indebtedness] shall be applied at the corporate level.

As the Tenth Circuit recognized in Gitlitz, the timing of the attribute reduction brings § 108(b)(4)(A) into conflict with § 108(d)(7)(A). Under the Taxpayers' position, excluded COD income does not reduce S corporation losses as required by § 108(b)'s attribute reduction requirement if the reduction is made in the year following the year of discharge. Rather, current and suspended losses are deducted by the shareholders by virtue of their increased basis, thus offsetting other income the shareholders may have. In practice, there would be no income left to offset any tax attributes at the corporate level in the year following discharge.

The Commissioner argues that § 108(b)(4)(A) does not require that the reduction of tax attributes be made in the year following the year of discharge. See § 108(b)(4)(B) (reductions under § 108(b)(2)(A) & (D) [net operating loss and capital loss carryover] shall be made first in the loss for the taxable year of the discharge.) Faced with the same argument from the taxpayers in Gitlitz, the Tenth Circuit held:

> Although a close question, we ultimately conclude the taxpayers' theory is not compelling. According to § 108(d)(7)(A), tax attributes [sic] reductions must be applied at the corporate level with subchapter S corporations. Taxpayers' proposal would not give effect to the attribute reduction scheme. Taxpayers' approach, in fact, would thwart the purpose of the net operating loss tax attribute. . . . As we see it, § 108(b)(4)(A) is simply designed to compute certain tax applications . . . before reducing tax attributes. We do not read the statute as mandating that attribute reductions be made in the tax year following the year of the discharge. We concede that, if § 108(b)(4)(A) is read narrowly and in isolation, it is plausible to conclude Congress intended tax attributes to be reduced only in the tax year following the taxable year of the discharge. But we must read the Internal Revenue Code as a whole. . . . Taxpayers' interpretation of § 108(b)(4)(A) would negate the effect of the tax attribution scheme and would give taxpayers an unwarranted windfall.

Gitlitz, 182 F.3d at 1149. In Witzel, without specifically addressing the ordering requirements of § 108(b)(4)(A), the Seventh Circuit determined that the tax attributes must be reduced before COD income passes through: "if (b) [§ 108(b)] is to be applied at the corporate level, the implication . . . is that the excluded income must be set off against the suspended losses and the latter reduced accordingly. The argument is not conclusive; the interpretive question could

be resolved either way; but in these circumstances of dubiety the sensible result — denying the taxpayers the double windfall — seems to us the preferable one." Witzel, 200 F.3d at 497.

While this is a very close call, we feel inclined to follow the reasoning of the Tenth and Seventh Circuits on the ordering issue. Section 108(d)(7)(A) clearly requires that the insolvency determination and the attribute reduction take place at the corporate level. If the attribute reduction is made after the COD income passes through then there will be no attribute reduction at the corporate level. As the Commissioner notes, the mandated reduction of the corporation's net operating losses (which include suspended shareholder losses) would never occur since there would be no income left at the corporate level to apply against the losses. While § 108(b)(4)(A) provides that the reduction in attributes shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge, it does not preclude the reduction of certain attributes in the year of discharge. Specifically, § 108(b)(4)(B) provides that reductions of net operating loss for the taxable year of discharge and any net operating loss carryover and any capital loss carryover shall be made "first in the loss for the taxable year of discharge." Thus, the corporation must determine its net operating losses and suspended operating losses for the year of discharge and reduce those attributes by the amount of COD income realized. If the losses exceed the COD income, then the extra losses pass through to the shareholders.

We disagree with the Tax Court and the Tenth Circuit in their findings that COD income is not income within the

meaning of § 1366(a)(1)(A) and thus does not pass through to the shareholders and increase the basis of their shares. Section 1366(a)(1)(A) explicitly includes tax-exempt income. The Tax Court and the Tenth Circuit have determined that COD income is not really tax-exempt since COD income reduces suspended losses and thus operates to defer rather than eliminate taxes. However, as Judge Posner explained in Witzel, COD income is not always tax deferred; it may be truly tax exempt if there are no suspended losses to offset the income. Moreover, § 1366 is not "limited to tax-exempt income, so if COD income is not 'really' tax exempt this would not take it out of the section." Witzel, 200 F.3d at 498.

Since COD income falls within § 1366(a)(1)(A), it follows that pursuant to § 1367(a)(1)(A), COD income increases the basis of the S corporation shareholder's stock by the amount of COD income passed through to the shareholder. Consequently, we hold that the S corporation must reduce any existing tax attributes, including shareholder suspended losses, by the amount of COD income realized by the S corporation. If any COD income remains after losses and suspended losses are deducted, that income may flow through to the shareholders pursuant to § 1366 and increase the shareholder's basis pursuant to § 1367. The shareholder may then use his increased basis to deduct any losses that may accumulate in the future.

In this case Four A realized $1,289,048 in COD income. Each shareholder deducted $309,914 in suspended and ordinary losses. The shareholders' combined losses ($1,239,656) are completely offset by the $1,289,048 in COD

income. Accordingly, the losses were not available to the Taxpayers to use as deductions on their 1993 returns and the Tax Court's disallowance of the deductions is affirmed.[9]

II. Bad Debt Deduction

The Tax Court held that Appolo was not entitled to a bad debt deduction under § 166 for amounts advanced to Four A because the debt was guaranteed by Four A's shareholders and the Guarantees were enforceable under Kentucky law. The Taxpayers contend that the Guarantees were invalid and unenforceable due to lack of consideration. The question of whether a contract lacks consideration is a fact question, subject to review for clear error. See Prichard v. Bank Josephine, 723 S.W.2d 883, 886 (Ky.Ct.App.1987); Roach v. United States, 106 F.3d 720, 723 (6th Cir.1997).

The Tax Court found that the first guaranty, the "Continuing Guaranty," stated that Appolo promised to forbear suing Four A on Four A's past debt; thus, the Continuing Guaranty was supported by adequate and sufficient consideration and is enforceable. Further, the Court found that the Four A shareholders were financially capable of satisfying the Guarantees. The Asher Taxpayers argued that while the Continuing Guaranty recites that Appolo promised to forbear suing Four A on Four A's past debt, Appolo never actually made such a promise. The Tax Court

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9. Because the Taxpayers' losses were less than the amount of COD income realized by Four A, each taxpayer is entitled to increase the basis of their stock by their share of the excess COD income. Since Four A is no longer operating, however, it is unlikely that the corporation will incur future losses.

noted that the only evidence submitted to disprove the existence of Appolo's promise was "their own selfserving testimony," which the Court, citing Tokarski v. Commissioner, 87 T.C. 74, 1986 WL 22155 (1986), declined to accept.

The Asher Taxpayers contend that the Tax Court improperly ignored their evidence demonstrating that the Guarantees lacked valid consideration. They maintain that "it is inconceivable that Four A's shareholders would have put their personal assets on the line in exchange for Appolo's collection forbearance of Appolo's future advances to Four A." The Asher Taxpayers assert that Tokarski, and the line of cases cited therein, which stand for the proposition that the court need not accept a petitioner's self-serving testimony when it is uncorroborated and inconsistent with other facts and circumstances presented at trial, is distinguishable from the facts in this case.

In Tokarski, a taxpayer and his mother testified that a bank deposit by the taxpayer was an inheritance from his father, not income from working. The taxpayer testified that he had never worked and that he received funds to live on from his uncles. The court found it incredible that the taxpayer, who appeared to be a normal, healthy, 32-year old, had never been productively employed. The court noted that it weighed against the taxpayer that he did not offer any corroborative testimony from his uncles or offer any explanation for not doing so. The court also questioned the taxpayer's proffered reason for waiting 6 weeks to deposit the money. "Under all the circumstances," the court held, "we are not required to accept the self-serving testimony

of petitioner or that of his mother as gospel." Tokarski, 87 T.C. at 77.

The Taxpayers argue that, unlike the situation in Tokarski, the testimony of each Taxpayer was internally consistent with and corroborated by the other Taxpayers' testimony. They also point to the testimony of non- taxpayers, Mr. Stites, Appolo's legal counsel, who testified that he was not directed by Mr. Gaudiano or Appolo to include the consideration language in the Guarantees; and Mr. McGowan, the Price Waterhouse auditor, "who corroborated the Taxpayers' testimony that Appolo never made promises to the Four A shareholders regarding future advances or collection forbearance and that the Guaranties were respectively backdated to January 1, 1989, and April 30, 1990, to give the appearance of enforceability." Appellant's Opening Brief at p. 56. Taxpayers also argue that with Four A hopelessly insolvent, any threat to foreclose on Four A's debt by Appolo would have been meaningless.

The Commissioner counters that Appolo's promise to forbear from suit was not meaningless for two reasons. First, Four A possessed sufficient assets to satisfy at least some of its indebtedness to Appolo at the time the Continuing Guaranty was executed. Second, the Guarantees resulted in a better financial statement for Appolo, from which the Ashers could benefit.

Moreover, upon review of the record, the non-taxpayer testimony of Mr. Stites and Mr. McGowan did not do much to corroborate the Taxpayers' testimony. Rather, the testimony simply informed the Court that Mr. Stites and Mr.

McGowan had no idea whether a promise was made or not. Indeed, Mr. McGowan testified that he believed that the Guarantees were valid and that he would not have accepted them if he believed that they were not valid.

Considering the Tax Court's ability to assess the demeanor of the witnesses and the credibility of the testimony provided by the witnesses, and the reasons why the Asher Taxpayers might have had motive to provide the Guarantees, we cannot find that the Tax Court clearly erred in disregarding the Taxpayers' testimony. A trial court's findings based on determinations regarding the credibility of witnesses are generally entitled to great deference. See Owens-Illinois, Inc. v. Aetna Cas. & Sur. Co., 990 F.2d 865, 870 (6th Cir.1993); In re H.J. Scheirich Co., 982 F.2d 945, 949 (6th Cir.1993). Moreover, while a factfinder who does not believe the testimony of a witness may "simply disregard it," the disregarded testimony is usually not considered sufficient grounds for drawing the opposite conclusion. Bose Corp. v. Consumers Union of U.S., Inc., 466 U.S. 485, 512, 104 S.Ct. 1949, 1966, 80 L.Ed.2d 502 (1984).

Absent the testimony of the Taxpayers regarding the alleged lack of consideration, the Guarantees appear on their faces to be valid and enforceable. Indeed the testimony of the Price Waterhouse auditor was compelling on that point. Accordingly, we do not find clear error in the Tax Court's finding that the Continuing Guaranty was valid and enforceable; and therefore, the Asher Taxpayers' bad debt deductions were properly disallowed.

Appendix A

Conclusion

For the reasons stated herein, the Tax Court's disallowance of all of the deductions in dispute is AFFIRMED. Specifically, the Taxpayers were not entitled to deduct their suspended and ordinary losses for tax year 1993 because those losses were offset at the corporate level by the COD income realized by Four A. To the extent that COD income remains after exhausting the current and suspended losses of Four A (and its shareholders), such COD income passes through to the shareholders and increases their basis in their stock. In addition, the Asher Taxpayers were not entitled to a bad debt deduction because the debt was guaranteed by the valid and enforceable Guarantees of the Four A Taxpayers.

APPENDIX B — MEMORANDUM FINDINGS OF FACT AND OPINION OF THE UNITED STATES TAX COURT DATED AND FILED NOVEMBER 13, 1998

T.C. Memo. 1998-408

UNITED STATES TAX COURT

Docket Nos. 25712-96, 25713-96,
25714-96, 25716-96

SALVADOR A. AND KATHLEEN M. GAUDIANO, ET AL.,[1]

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Filed November 13, 1998.

* * *

MEMORANDUM FINDINGS OF FACT AND OPINION

VASQUEZ, *Judge*: Respondent determined the following deficiencies in petitioners' 1993 Federal income taxes:

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1. Cases of the following petitioners are consolidated herewith: Gary D. Asher, docket No. 25713-96; Larry A. Asher, docket No. 25714-96; and Randy C. and Kathleen R. Edgemon, docket No. 25716-96.

Appendix B

Petitioner	Deficiency
Salvador A. and Kathleen M. Gaudiano (S. and K. Gaudiano)	$43,665
Gary D. Asher (G. Asher)	43,281
Larry A. Asher (L. Asher)	43,858
Randy C. and Kathleen R. Edgemon (R. and K. Edgemon)	44,342

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

The issues for decision are: (1) Whether petitioners[2] are entitled to increase their bases in the stock of Four A Coal Co. (Four A), an S corporation, by their pro rata share of discharge of indebtedness income (COD income) realized by Four A but excluded by Four A pursuant to section 108(a); (2) whether the transfer of certain mining equipment by Four A constituted a sale or a lease and, if a sale, then the amount realized on the sale; (3) whether G. Asher and L. Asher are entitled to ordinary losses related to an alleged bad debt deduction claimed by Appolo Fuels, Inc. (Appolo), an S corporation, for loans made to Four A.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the attached exhibits are

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2. We use the term "petitioners" to refer to S. Gaudiano, G. Asher, L. Asher, and R. Edgemon.

incorporated herein by this reference. S. and K. Gaudiano and R. and K. Edgemon resided in Knoxville, Tennessee, at the time they filed their petitions. G. Asher resided in Middlesboro, Kentucky, at the time he filed his petition, and L. Asher resided in Speedwell, Tennessee, at the time he filed his petition.

I. *Increase in Basis of Four A Stock*

During 1993, petitioners were shareholders of Four A, an S corporation. Petitioners each held a 25-percent interest in Four A.

During 1993, Four A had COD income of $1,289,048. On December 3, 1993, Four A filed for bankruptcy and was insolvent within the meaning of section 108(d)(3). On its Form 1120S for 1993, Four A excluded the COD income under section 108(a). During that year, each petitioner increased his basis in his Four A stock by $322,262 — this represented his pro rata share of Four A's COD income for the year.

II. *Increased Section 1231 Loss*

From May 1988 through February 1991, Four A mined coal which it sold to Appolo. Four A ceased its mining operations in February 1991, and it leased its mining equipment (the equipment) to Black Mountain Coal Mining Co., Inc. (Black Mountain). Pursuant to the lease with Black Mountain (the lease), Black Mountain mined the coal seams formerly mined by Four A and sold the coal to Appolo. Appolo paid Black Mountain a certain price per ton for coal

produced and paid Four A 50 cents per ton of coal produced as a fee for Black Mountain's use of the equipment. Under the terms of the lease, Four A retained title to the equipment.

During 1993, Four A and Black Mountain entered into a new agreement concerning the equipment referred to by the parties as a "Promissory Note and Agreement" (the agreement). According to the terms of the agreement, Four A granted, sold, and conveyed all of its right, title, and interest in and to the equipment to Black Mountain. Four A retained a security interest in the equipment as protection against nonpayment by Black Mountain.

The agreement required Black Mountain to pay a total purchase price of $445,000 for the equipment. The purchase price was to be paid monthly out of Black Mountain's production at a rate of 17 cents per ton of coal produced in the preceding month.

The agreement also provided that if Black Mountain failed to make production payments, then the entire indebtedness became immediately due and payable. In such event, Black Mountain could retain the equipment by paying the balance of the debt. If Black Mountain chose not to pay the remaining balance, it was required to return the equipment to Four A. The agreement provided that the debt was nonrecourse. In late 1995 or early 1996, Black Mountain ceased making production payments and surrendered the equipment to Four A. The equipment was ultimately sold to a third party.

On its Form 1120S for 1993, Four A reported the transfer of the equipment as a sale and reported the amount realized

on the sale as $445,000 (the total purchase price under the agreement). This resulted in a section 1231 loss of $275,006. In 1996, Four A filed an amended Form 1120S which reported the amount realized on the sale as $145,430. This increased the section 1231 loss to $574,576. In 1996, petitioners filed Forms 1040X seeking refunds for 1993 based on their pro rata shares of the increased section 1231 loss from Four A.

III. *Business Bad Debt Deduction*

From 1988 to May 6, 1991, Four A sustained substantial losses, and Appolo advanced significant amounts of money to Four A on a demand basis for the working capital needs of Four A (Four A debt). During 1993, G. Asher and L. Asher were shareholders of Appolo, each owning 24 percent of its outstanding shares. John Asher, their father, was the majority shareholder of Appolo.

In March 1991, Price Waterhouse LLP (PW) audited Appolo's 1990 financial statements. During the audit, PW questioned the collectability of the Four A debt and suggested that Appolo establish a reserve against the Four A debt. PW and S. Gaudiano, acting in his capacity as the chief financial officer of Appolo, reached an agreement whereby petitioners, acting in their capacity as Four A shareholders, would execute guaranties to Appolo for the Four A debt, and Appolo would not be required to establish a reserve against the Four A debt.

On or about May 13, 1991, petitioners executed two guaranty agreements. Both guaranties stated that they were

supported by adequate and sufficient consideration. The first guaranty covered all loans made by Appolo to Four A in the past and to be made in the future. The first guaranty stated that it was given for good and valuable consideration and "as consideration for Appolo not demanding immediate payment of its existing loans to Four A and as an inducement to Appolo to make future advances to Four A".

At the time of Four A's bankruptcy in 1993, Four A owed $1,106,000 to Appolo. In 1993, Appolo wrote off the Four A debt as a business bad debt under section 166 without ever demanding payment from either Four A or the Four A shareholders. As a result, on their respective 1993 Federal income tax returns, G. Asher and L. Asher each reported an ordinary loss of $80,246 as their distributive share of Appolo's bad debt deduction. During 1993, the Four A shareholders had the financial ability to honor the guaranties, and they currently still have such ability.

OPINION

I. *Basis in Four A Stock*

Petitioners argue that they are entitled to increase their bases of their Four A stock as a result of Four A's 1993 realization of COD income that was excluded under section 108(a). After the initial briefs were filed by the parties, *Nelson v. Commissioner*, 110 T.C. 114 (1998), was released by the Court. In his reply brief, respondent relies upon *Nelson*. Petitioners do not attempt to distinguish *Nelson* from the instant case but instead assert that *Nelson* was incorrectly decided.

Appendix B

In *Nelson*, we held that COD income realized and excluded from gross income under section 108(a) does not pass through to shareholders of an S corporation as an item of income in accordance with section 1366(a)(1) so as to enable an S corporation shareholder to increase the basis of his stock under section 1367(a)(1). We held in that case that section 108 is not designed or intended to be a permanent exemption from tax. *Id.* at 125. Excluded COD income is not "tax-exempt" pursuant to section 1366(a)(1) and, thus, is not statutorily required to pass through to the S corporation shareholders. *Id.*

We see no need to repeat our detailed analysis on this issue contained in *Nelson*. See *Friedman v. Commissioner*, T.C. Memo. 1998-196; *Chesapeake Outdoor Enters., Inc. v. Commissioner*, T.C. Memo. 1998-175. We hold, following *Nelson*, that the COD income in the amount of $1,289,048 that Four A excluded from gross income under section 108(a) is not a separately stated item of tax-exempt income for purposes of section 1366(a)(1)(A). Therefore, petitioners are not entitled to increase their bases in the Four A stock due to Four A's COD income.

II. *Increased Section 1231 Loss*

In 1996, petitioners filed claims for refund for their distributive shares of the increased section 1231 loss claimed by Four A on its 1993 amended Form 1120S. Respondent argues that (1) the transaction was a lease and not a sale, and (2) if it was a sale, the amount realized from the sale should be $445,000, the amount originally reported by Four A on its return, instead of $145,430 as reported by Four A on its amended return.

Appendix B

A. *Sale v. Lease*

In 1993, Four A and Black Mountain executed a new agreement concerning the equipment. The agreement characterized the transaction as a sale of the equipment.

It is well settled that the economic substance of transactions, rather than their form, governs for tax purposes. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1236 (1981). In deciding whether a transaction constitutes a sale for tax purposes, we consider whether the burdens and benefits of ownership have passed to the purported purchaser. See *id.* at 1237. This is a question of fact to be ascertained from the intentions of the parties as evidenced by the written agreements read in the light of the attending facts and circumstances. *Id.* In ascertaining such intent, no single factor, or any special combination of factors, is absolutely determinative. *Cal-Maine Foods, Inc. v. Commissioner*, T.C. Memo. 1977-89; see also *Western Contracting Corp. v. Commissioner*, 271 F.2d 694 (8th Cir. 1959); *Benton v. Commissioner*, 197 F.2d 745 (5th Cir. 1952); *Haggard v. Commissioner*, 24 T.C. 1124 (1955), affd. per curiam 241 F.2d 288 (9th Cir. 1956).

In *Grodt & McKay Realty, Inc. v. Commissioner*, *supra* at 1237-1238, we listed several factors considered by courts in determining whether the benefits and burdens of ownership have been transferred. The factors considered were:

> (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract

creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. [Citations omitted.]

1. *Whether Legal Title Passed*

We look to State law to determine whether a taxpayer has an ownership interest in property. See *United States v. National Bank of Commerce*, 472 U.S. 713 (1985). Under Kentucky law, "title to goods passes * * * in any manner and on any conditions explicitly agreed on by the parties." Ky. Rev. Star. Ann. sec. 355.2-401(1) (Michie 1996). Petitioners argue that under the agreement Four A granted, sold, and conveyed all of its right, title, and interest in and to the equipment to Black Mountain. Respondent argues that there is no evidence that legal title was actually transferred to Black Mountain and points out that no bill of sale was given to Black Mountain.

The parties to the agreement designated that title passed with the signing of the agreement, and under Kentucky law, the parties' designation controls. We conclude that legal title passed to Black Mountain on the execution of the agreement.

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2. *How the Parties Treated the Transaction*

Four A recorded the transaction as a sale in its bankruptcy filings and ceased taking depreciation deductions related to the equipment after executing the agreement. Respondent argues that Black Mountain treated the transaction as a lease and relies on the testimony of William Phipps, president of Black Mountain, for this proposition. Mr. Phipps testified that the transaction was a "lease purchase" and not a sale. However, during cross-examination, Mr. Phipps admitted that he did not know the difference between a lease purchase and a sale agreement and that the purpose in executing the note was to gain ownership of the equipment. Mr. Phipps also conceded that his partner, Mr. Donovan, did most of the negotiating with Four A regarding the equipment.

We find that the parties to the agreement treated the transaction as a sale.

3. *Other Factors*

The parties failed to present evidence regarding which party bore the risk of loss or damage to the equipment. Under the agreement, Four A had a present obligation to convey title to Black Mountain (as noted above), and Black Mountain had a present obligation to make production payments to Four A in order to retain the equipment. Additionally, Black Mountain had possession of the equipment. Black Mountain was required to return the equipment to Four A if it stopped making production payments and failed to pay the remaining balance due under the agreement.

4. *Conclusion*

Based on our review of the relevant *Grodt & McKay Realty* factors, we conclude that the transaction concerning the equipment constituted a sale by Four A.

B. *Amount Realized From the Sale*

On Four A's Form 1120S for 1993, Four A reported the amount realized on the sale of the equipment as $445,000. In 1996, Four A filed an amended Form 1120S that reported the amount realized on the sale as $143,430. This increased Four A's section 1231 loss to $574,576. Petitioners filed Forms 1040X seeking refunds for 1993 based on Four A's increased section 1231 loss.[3]

Section 1001(b) provides that "The amount realized from the sale or other disposition of property shall be the sum of any money received plusthe fair market value of the property (other than money) received." Petitioners argue that under section 1.1001-1(g)(2), Income Tax Regs., Four A was entitled to report the amount realized on the sale as the present value of the productions payments to be made under the agreement.

In 1996, final regulations were issued providing a method for calculating the amount realized from a contingent

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3. We note that petitioners never received any response from respondent regarding their amended Forms 1040X and that this issue was not included in the statutory notices of deficiency or in the petitions. We find that the issue was tried by consent pursuant to Rule 41(b)(1), and we consider it to be before the Court.

payment debt instrument. Sec. 1.1001-1(g)(2), Income Tax Regs. Treasury Decision 8674, explaining the final regulations, provides in part:

> For a contingent payment debt instrument issued before August 13, 1996, a taxpayer may use any reasonable method to account for the debt instrument, including a method that would have been required under the proposed regulations when the debt instrument was issued. * * * [T.D. 8674, 1996-2 C.B. 84, 89.]

The agreement for the sale of the equipment was executed in 1993, before the effective date of the 1996 regulations. Petitioners contend, as we understand it, that Four A received, in exchange for the equipment, a contingent payment debt instrument within the meaning of the regulations. Even if we accept that premise arguendo, petitioners bear the burden of proving that the method they used to compute the amount realized was reasonable in light of the facts and circumstances.

S. Gaudiano testified that he computed the amount realized of $145,430 on Four A's amended Form 1120S using two different methods: (1) A balloon payment calculation using a normal banking rate of 11-1/4 percent and (2) a junk bond calculation using a 24- to 25-percent discount rate. S. Gaudiano testified that the two methods reached similar results.

Neither Four A nor petitioners showed the present value calculations on their amended returns, and during his

testimony S. Gaudiano failed to explain to the Court how either of his two alleged methods arrived at an amount realized of $145,430. From the record, we are unable to discern the specific methodology employed by S. Gaudiano in making the present value calculations. Thus, petitioners have failed to establish that the method they used to compute the amount realized of the note was reasonable or had a basis in fact. We conclude that petitioners have not established that they are entitled to increase their section 1231 losses relating to the sale of the equipment by Four A.

III. *Bad Debt Deduction*

From 1988 to May 6, 1991, Appolo advanced significant amounts of money to Four A for its working capital needs. In 1991, petitioners, in their capacity as Four A shareholders, executed two personal guaranty agreements that covered the debt Four A owed to Appolo. In 1993, Four A declared bankruptcy, and Appolo wrote off the Four A debt and claimed a bad debt deduction under section 166. As a result, on their respective 1993 Federal income tax returns, G. Asher and L. Asher each reported ordinary losses of $80,246 as their distributive share of Appolo's bad debt deduction.

In the answer, respondent, for the first time, disallowed these ordinary losses and asserted increased deficiencies in the income taxes of G. Asher and L. Asher. When a new matter is pleaded in the answer, the burden of proof for that issue is on respondent. Rule 142(a).

If Appolo is entitled to a bad debt deduction, then G. Asher and L. Asher are entitled to ordinary losses related

to their distributive shares of the deduction. Respondent argues that Appolo is not entitled to a bad debt deduction under section 166 for the Four A debt because the Four A shareholders signed personal guaranties and had the financial ability to repay the Four A debt; therefore, the debt was not worthless as required under section 166. G. Asher and L. Asher argue that the guaranties were not supported by adequate and sufficient consideration and are not enforceable; therefore, the debt is worthless, and Appolo is entitled to a bad debt deduction.

On their face, the guaranties appear valid and enforceable. Both guaranties stated, on their face, that they were supported by adequate and sufficient consideration. The first guaranty stated that it was supported by two forms of consideration: (1) Appolo's promise not to demand immediate payment on past loans made to Four A, and (2) Appolo's promise to make future loans to Four A.[4]

It is well settled under Kentucky law that forbearance to sue is a sufficient consideration to support a promise. *Sellars v. Jones*, 175 S.W. 1002, 1003 (Ky. Ct. App. 1915). The first guaranty stated that Appolo promised to forbear suing Four A on Four A's past debt; thus, the first guaranty was supported by adequate and sufficient consideration and is enforceable.

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4. By its terms, the first guaranty covers all loans made by Appolo to Four A. If the first guaranty is enforceable, then the debt is not worthless regardless of whether the second guaranty is enforceable, and Appolo is not entitled to a bad debt deduction for the debt.

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G. Asher and L. Asher argue that although the guaranty recites that Appolo promised to forbear suing Four A on Four A's past debt, Appolo never actually made such a promise to the Four A shareholders. The only evidence submitted by petitioners to disprove the existence of that promise was their own self-serving testimony. Under these circumstances, we are not required to and do not accept the self-serving testimony of petitioners. See *Tokarski v. Commissioner*, 87 T.C. 74 (1986).

We conclude that the first guaranty was supported by adequate and sufficient consideration and was enforceable. Therefore, Appolo is not entitled to a bad debt deduction for the Four A debt, and, accordingly, G. Asher and L. Asher are not entitled to ordinary losses related to the bad debt deduction.

To reflect the foregoing,

Decisions will be entered under Rule 155.

APPENDIX C — STIPULATION OF FACTS OF THE UNITED STATES TAX COURT DATED AND FILED NOVEMBER 17, 1997

UNITED STATES TAX COURT

Docket Nos. 25712-96
25713-96
25714-96
25716-96

SALVADOR A. and KATHLEEN M. GAUDIANO, et al.

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION OF FACTS

Pursuant to Rule 91 of the Tax Court Rules of Practice, the parties hereby stipulate that, for the purposes of these consolidated cases, the following statements may be accepted as true and the following exhibits attached hereto may be accepted as authentic and are incorporated in this stipulation and made a part hereof; provided, however, that the parties reserve the right to object to the admission of any such facts and exhibits in evidence on the grounds of materiality and relevancy, and provided further, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

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1. At the time the petitions in these cases were filed, the residences of these petitioners were as follows:

Gary D. Asher
W. Winchester Avenue
Post Office Box 1727
Middlesboro, Kentucky 40965

Larry A. Asher
Route 1, Thompson
Speedwell, TN 37870

Salvador A. and Kathleen M. Gaudiano
12121 Fox Den Drive South
Knoxville, Tennessee 37922

Randy C. and Kathleen R. Edgemon
12805 Kingston Pike
Knoxville, Tennessee 37922

2. On October 16, 1996, the respondent timely sent the petitioner Gary Asher, via certified mail, a statutory notice of deficiency for the taxable year 1993. A copy of said statutory notice of deficiency is attached hereto as Joint Exhibit 1-A.

3. On October 16, 1996, the respondent timely sent the petitioner Larry Asher, via certified mail, a statutory notice of deficiency for the taxable year 1993. A copy of said statutory notice of deficiency is attached hereto as Joint Exhibit 2-B.

4. On September 12, 1996, the respondent timely sent the petitioners Randy and Kathleen Edgemon, via certified mail, a statutory notice of deficiency for the taxable year 1993. A copy of said statutory notice of deficiency is attached hereto as Joint Exhibit 3-C.

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5. On September 12, 1996, the respondent timely sent the petitioners Salvador and Kathleen Gaudiano, via certified mail, a statutory notice of deficiency for the taxable year 1993. A copy of said statutory notice of deficiency is attached hereto as Joint Exhibit 4-D.

6. On August 9, 1994, the petitioner Gary Asher timely filed Form 1040, U.S. Individual Income Tax Return, for the taxable year 1993 with the Internal Revenue Service. A copy of said Form 1040 is attached hereto as Joint Exhibit 5-E.

7. On August 19, 1994, the petitioner Gary Asher filed Form 1040X, Amended U.S. Individual Income Tax Return, for the taxable year 1993 with the Internal Revenue Service. A copy of said Form 1040X is attached hereto as Joint Exhibit 6-F.

8. On or around March 25, 1996, the petitioner Gary Asher delivered a Form 1040X, Amended U.S. Individual Income Tax Return, for the taxable year 1993 to the Internal Revenue Service. Although received by the Internal Revenue Service, the Form 1040X dated March 25, 1996 was not processed by the Internal Revenue Service. A copy of said Form 1040X is attached hereto as joint Exhibit 7-G.

9. On August 9, 1994, the petitioner Larry Asher timely filed Form 1040, U.S. Individual Income Tax Return, for the taxable year 1993 with the Internal Revenue Service. A copy of said Form 1040 is attached hereto as Joint Exhibit 8-H.

10. On October 10, 1994, the petitioner Larry Asher filed Form 1040X, Amended U.S. Individual Income Tax Return, for the taxable year 1993 with the Internal Revenue Service. A copy of said Form 1040X is attached hereto as Joint Exhibit 9-I.

11. On or around March 21, 1996, the petitioner Larry Asher delivered a Form 1040X, Amended U.S. Individual Income Tax Return, for the taxable year 1993 to the Internal Revenue Service. Although received by the Internal Revenue Service, the Form 1040X dated March 21, 1996 was not processed by the Internal Revenue Service. A copy of said Form 1040X is attached hereto as Joint Exhibit 10-J.

12. On July 19, 1994, the petitioners Randy and Kathleen Edgemon timely filed Form 1040, U.S. Individual Income Tax Return, for the taxable year 1993 with the Internal Revenue Service. A copy of said Form 1040 is attached hereto as Joint Exhibit 11-K.

13. On or around March 21, 1996, the petitioners Randy and Kathleen Edgemon delivered a Form 1040X, Amended U.S. Individual Income Tax Return, for the taxable year 1993 to the Internal Revenue Service. Although received by the Internal Revenue Service, the Form 1040X dated March 21, 1996 was not processed by the Internal Revenue Service. A copy of said Form 1040X is attached hereto as Joint Exhibit 12-L.

14. On July 25, 1994, the petitioners Salvador and Kathleen Gaudiano timely filed Form 1040, U.S. Individual Income Tax Return, for the taxable year 1993 with the

Internal Revenue Service. A copy of said Form 1040 is attached hereto as Joint Exhibit 13-M.

15. On or around March 21, 1996, the petitioners Salvador and Kathleen Gaudiano delivered a Form 1040X, Amended U.S. Individual Income Tax Return, for the taxable year 1993 to the Internal Revenue Service. Although received by the Internal Revenue Service, the Form 1040X dated March 21, 1996 was not processed by the Internal Revenue Service. A copy of said Form 1040X is attached hereto as Joint Exhibit 14-N.

16. On July 11, 1994, Four A Coal Company (hereinafter "Four A") timely filed Form 1120S, U.S. Income Tax Return for an S Corporation, for the period January 1, 1993 through December 2, 1993 with the Internal Revenue Service. A copy of said Form 1120S is attached hereto as Joint Exhibit 15-O.

17. Attached hereto as Joint Exhibit 16-P is a copy of Four A's amended Form 1120S for the period January 1, 1993 through December 2, 1993. Although received by the Internal Revenue Service, the amended Form 1120S has not been processed by the Internal Revenue Service.

18. At all times during 1993, Four A was a Subchapter S corporation.

19. At all times during 1993, petitioners Larry Asher, Gary Asher, Randy Edgemon and Salvador Guadiano were shareholders of Four A, each owning 25% of the outstanding shares.

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20. On December 3, 1993, Four A filed for protection under Chapter 7 of the Bankruptcy Code and was insolvent within the meaning of I.R.C. §108(d)(3).

21. In 1993, Four A had cancellation of indebtedness income within the meaning of I.R.C. §108 and §61(a)(12) (hereinafter "COD income") of $1,289,048.00.

22. The amended Form 1120S of Four A for tax year 1993, increased its reported §1231 loss from $275,006.00 to $574,576.00.

23. At the beginning of 1993, each petitioner/shareholder had a zero basis in both the stock and debt of Four A and had suspended losses from prior years pursuant to I.R.C. §1366(d)(2) of $189,779.00.

24. During 1993, each petitioner/shareholder invested $119,000.00 in Four A thereby increasing his basis in his Four A stock by $119,000.00.

25. Each petitioner/shareholder of Four A increased his basis in his Four A debt by $322,262.00, representing his 25% share of Four A's COD income reported by Four A for 1993.

26. Petitioners each used such increase in basis to deduct $51,383.00 in ordinary losses and $68,752.00 in §1231 losses for tax year 1993 and $189,779.00 in suspended losses from prior tax years.

27. The shares of Four A owned by petitioners became totally worthless within the meaning of I.R.C. §165(g) in

1993 and each petitioner(s) also initially reported a capital loss on the disposition of his Four A stock in 1993 of $157,066.00.

28. As a result of Four A's filing of an amended Form 1120S for 1993, each petitioner(s) filed a Form 1040X, seeking respective refunds for the 1993 tax year as follows (based on an additional claimed §1231 loss from Four A), and acknowledging a corresponding decrease in the capital loss on Four A shares initially reported in 1993:

	Additional Deduction	Refund	Revised Capital Loss
Larry Asher	$74,893.00	$28,446.00	$61,953.00
Gary Asher	74,892.00	28,018.00	61,953.00
Randy Edgemon	74,893.00	25,860.00	61,953.00
Salvador Gaudiano	74,892.00	27,858.00	61,953.00

29. Petitioners have received no response from respondent in regard to their amended returns referenced in Stipulation Paragraphs 8, 11, 13 and 15.

30. If respondent prevails, petitioner(s) will not have a capital loss from Four A stock in 1993 and will owe the deficiency amounts set forth in the notice of assessment issued to such petitioner(s).

31. On July 13, 1994, Appolo Fuels, Inc. (hereinafter "Appolo") filed Form 1120S, U.S. Income Tax Return for an S Corporation, for the calendar year 1993 with the Internal Revenue Service. A copy of said Form 1120S is attached hereto as Joint Exhibit 17-Q.

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32. During 1993, Appolo was a Subchapter S corporation, engaged in the mining and sale of coal in the state of Kentucky.

33. Petitioners Larry Asher and Gary Asher were shareholders of Appolo in 1993, each owning 24% of the outstanding shares.

34. From May 1988 through February 1991, Four A mined coal which it sold to Appolo under contract and which Appolo used to meet its contractual obligations to deliver coal to various purchasers.

35. During the period from 1988 through May 6, 1991 Four A sustained substantial losses and Appolo lent a significant amount to Four A through the advancement of funds and payment of Four A expenses.

36. From 1988 through February of 1991, Four A was a supplier of coal to Appolo.

37. Attached hereto as Joint Exhibit 18-R is a schedule showing Appolo's loans to Four A and repayment of such loans by Four A.

38. Four A ceased mining operations in February of 1991 and leased its mining equipment to Black Mountain Coal Company ("Black Mountain"), an independent operator, who agreed with Appolo to mine the coal seams formerly mined by Four A and to sell such coal to Appolo. Pursuant to the agreement with Black Mountain, Appolo would pay Black Mountain $18.50/ton for the coal (rather than the

$19.00/ton it had been paying Four A) and would pay Four A $0.50/ton as a fee for Black Mountain using Four A's mining equipment.

39. On or about May 13, 1991, petitioners Larry Asher, Gary Asher, Salvador Gaudiano and Randy Edgemon executed two guaranty agreements (the "Guaranties") relative to the Four A indebtedness owed to Appolo, one dated as of January 1, 1989 and one dated as of April 30, 1990. Attached hereto as Joint Exhibit 19-S is a copy of the guaranty agreement dated January 1, 1989. Attached hereto as Joint Exhibit 20-T is a copy of the guaranty agreement dated April 30, 1990.

40. No advances or loans were made by Appolo to Four A after the execution of the Guaranties.

41. At the time of Four A's bankruptcy in 1993, Four A still owed $1,106,000.00 to Appolo.

42. As a result of Four A's bankruptcy proceedings, in 1993 Appolo claimed a bad debt deduction under I.R.C. §166 of $1,150,620.00, of which $1,106,000.00 related to the loans and advances made by Appolo to Four A which were not repaid.

43. In connection with their ownership of Four A stock, petitioners Larry Asher and Gary Asher each reported an ordinary loss of $80,246.00 on his individual 1993 tax return.

44. In its answers to the petitions of Larry and Gary Asher, the respondent disallowed Appolo's bad debt

deduction relating to the debts owed from Four A, thereby increasing Gary Asher's deficiency from $43,281.00 to $141,810.50 and Larry Asher's deficiency from $43,858.50 to $142,388.68.

45. The increased deficiency is based solely on the disallowance of the distributive share of the bad debt deduction from Appolo.

46. The parties agree that if the Guarantees referenced in Stipulation Paragraph 39 are valid and enforceable, the petitioners had (have) the financial ability to repay the Four A indebtedness to Appolo.

47. Attached hereto as Joint Exhibit 21-U is a copy of a Memorandum on Examination prepared by Price Waterhouse with respect to the audit of Appolo for 1990.

48. Attached hereto as Joint Exhibit 22-V is a copy of the proposed Four A "Debt Repayment Schedule".

49. Attached hereto as Joint Exhibit 23-W is a copy of a July 9, 1997 letter to the petitioner Salvador Gaudiano from John McGowen of Price Waterhouse.

50. Attached hereto as Joint Exhibit 24-X is a copy of Four A's bankruptcy petition and schedules filed with the United States Bankruptcy Court for the Eastern District of Kentucky.

51. Attached hereto as collective Joint Exhibit 25-Y is copy of the Amended Notice to Creditors and other Parties

in Interest filed with the Bankruptcy Court on November 14, 1994 and a copy of the Order Approving Sale entered by the Bankruptcy Court on December 21, 1994 in the bankruptcy proceeding of Four A.

52. Attached hereto as Joint Exhibit 26-Z is a copy of the Order of Distribution entered by the Bankruptcy Court on September 20, 1996 in the bankruptcy proceeding of Four A.

53. Attached hereto as Joint Exhibit 27-AA is a copy of the Financial Statements for Appolo for the periods ending December 31, 1989 and December 31, 1990 as audited by Price Waterhouse.

54. Attached hereto as Joint Exhibit 28-AB is a copy of a February 2, 1994 letter to the petitioner Salvador Gaudiano from James Golden.

55. Attached hereto as Joint Exhibit 29-AC is a copy of a Nonrecourse Note by and between Black Mountain Coal Mining Company, Inc. and Four A.

56. Attached hereto as Joint Exhibit 30-AD is a copy of an Agreement dated April 25, 1991 by and between Four A and Black Mountain Coal Company.

57. During the period December 3, 1993 to December 21, 1994, the Chapter 7 Trustee of the Four A bankruptcy collected $37,709.00 under the Nonrecourse Note from Black Mountain Coal Company.

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58. Attached hereto as Joint Exhibit 31-AE is a copy of an undated Agreement by and between Four A, Citizens Fidelity Bank and Trust Company, Gary Asher, Larry Asher, Randy C. Edgemon, Salvador A. Gaudiano and Appolo.

STUART L. BROWN
Chief Counsel
Internal Revenue Service

/s/ William C. Myers, Jr.
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Dated: 11/17/97

By: /s/ Rebecca Dance Harris
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Dated: NOV 17 1997

APPENDIX D — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT DENYING PETITION FOR REHEARING DATED AND FILED JULY 18, 2000

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

Case No. 99-1294

SALVADOR A. GAUDIANO; KATHLEEN M. GAUDIANO; GARY D. ASHER; LARRY A. ASHER; RANDY C. EDGEMON; KATHLEEN R. EDGEMON

Petitioners – Appellants

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent – Appellee

ORDER

BEFORE: BOGGS and NORRIS, Circuit Judges; NUGENT, District Judge.

Upon consideration of the petition for rehearing filed by appellant,

It is **ORDERED** that the petition for rehearing be, and it hereby is, **DENIED**.

ENTERED BY ORDER OF THE COURT

s/ Leonard Green
Leonard Green, Clerk

APPENDIX E — RELEVANT STATUTES

Internal Revenue Code of 1986 (26 U.S.C. (1993))

26 U.S.C. § 61(a)(12) (1993) provides, in pertinent part: "[G]ross income means all income from whatever source derived, including (but nor limited to) . . . [i]ncome from discharge of indebtedness . . . ."

26 U.S.C. § 108(a)(1)(B) (1993) provides: "Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if . . . the discharge occurs when the taxpayer is insolvent . . . ."

26 U.S.C. § 108(b)(1)-(3) (1993) provide, in pertinent part:

> (b) Reduction of tax attributes. —
>
> (1) In general. — The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).
>
> (2) Tax attributes affected; order of reduction. — Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

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(A) NOL. — Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit. — Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) Capital loss carryovers. — Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(D) Basis reduction. —

(i) In general. — The basis of the property of the taxpayer.

(ii) Cross reference. —

For provisions for making the reduction described in clause (i), see section 1017.

(E) Foreign tax credit carryovers. — Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

(3) Amount of reduction. —

(A) In general. — Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

(B) Credit carryover reduction. — The reductions described in subparagraphs (B) and (E) of paragraph (2) shall be 33 1/3 cents for each dollar excluded by subsection (a).

26 U.S.C. § 108(b)(4)(A) and (B) (1993) provide, in pertinent part:

(4) Ordering rules. —

(A) Reductions made after determination of tax for year. — The reductions described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.

(B) Reductions under subparagraph (A) or (C) of paragraph (2). — The reductions described in subparagraph (A) or (C) of paragraph (2) (as the case may be) shall be made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.

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26 U.S.C. § 108(d)(7) (1993) provides, in pertinent part:

> (7) Special rules for S corporation. —
>
> (A) Subsections (a), (b), and (g) to be applied at corporate level. — In the case of an S corporation, subsections (a), (b), and (g) shall be applied at the corporate level.
>
> (B) Reduction in carryover of disallowed losses and deductions. — In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year.

26 U.S.C. § 1366(a)(1)(A) (1993) provides, in pertinent part:

> In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . there shall be taken into account the shareholder's pro rata share of the corporation's — (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder. . . .

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26 U.S.C. § 1367(a)(1)(A) (1993) provides, in pertinent part:

> The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period: (A) the items of income described in subparagraph (A) of section 1366(a)(1) . . . .